**Financial Accounting**
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**Lecture – 103**
**7.14 Identifying hidden information (Part 2)**

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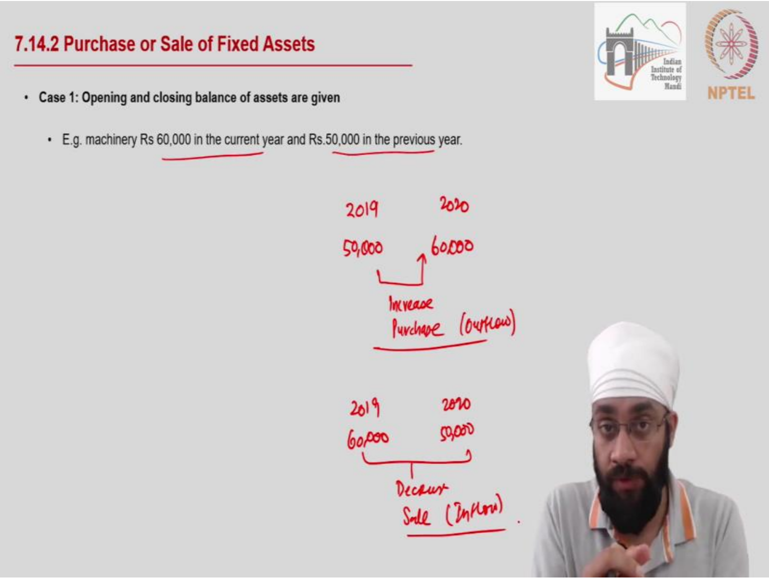


Alright, this is the continuation. We are going to discuss the case of purchase or sale of fixed assets and how to identify the missing piece of information. So, case 1 is where you have been given the opening and closing balance of the assets. So, let's say machinery 60,000 in the current year and 50,000 in the previous year.

When you started the year, you had 50,000 in the machinery account and now you have 60000. There is no other information available to you; the only thing that you can assume now is that there is an increase. Since there is an increase, this must be due to purchase. Purchase of the fixed asset, you consider it as an outflow from investing activities. The opposite of this could be that you have 60,000 at the beginning of the year and you have 50,000 at the end of the year. In this case again, if you have no information, you can easily consider this decrease to be a sale of the asset and an inflow. Accordingly, show this as part of the investing cash flows; the second subsection of the cash flow statement. This is case 1.

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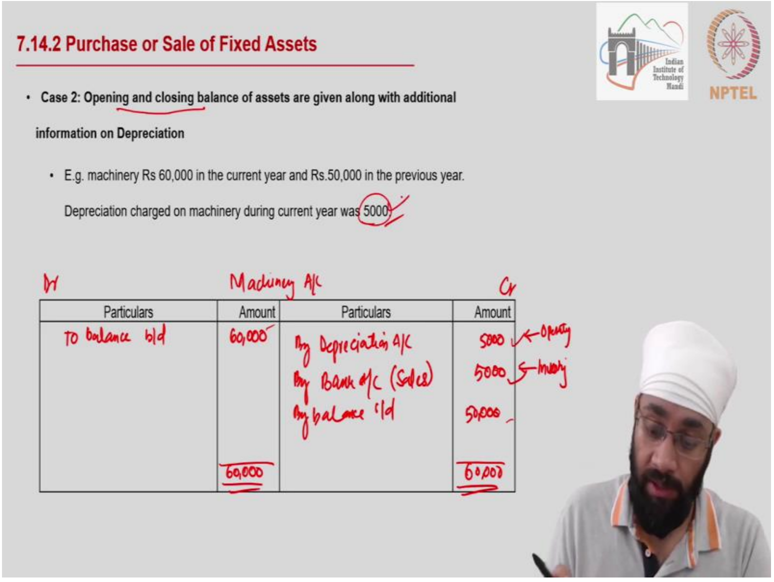


Let us go to case 2. Case 2 is that you have opening and closing balance given; but in addition, you have been given an amount of depreciation, let say 5,000 in this case. So, we are going to prepare a machinery account here, just to work out the hidden information. Although we have done this manually, more intuitively, let me explain the logic to you as well. So, a machinery account is an asset. We begin on the debit side To balance brought down, the opening balance was 60,000 and the closing balance is 50,000 and depreciation during the year is 5000. The journal entry for depreciation is: Depreciation debit, To fixed asset or To machinery. So, depreciation is going to be written here by depreciation account 5000.

Now, the value of the asset was going down from 60 to 50 by 10,000, but the whole 10,000 is not the sale of the asset. Out of the 10,000, 5,000 is due to the decrease in the value due to depreciation of 5,000. But clearly, there is a balancing figure. So, we are going to figure out the balancing figure. Total should be 60000 on both sides. There is a gap of 5000. What is this amount?

This is by bank account; this means, an asset has been sold. This is the balancing figure; 5,000 rupees worth of fixed assets has been sold. So, this amount goes into the investing activities. The depreciation amount goes to operating activities and it actually goes to operating activity, but you take it out of the operating activities.

This is a non-cash item. Although operating expense, this is a non-cash expense. So, you add it back to the profit to remove its effect. So, that is the second case, where the depreciation amount is given to you.

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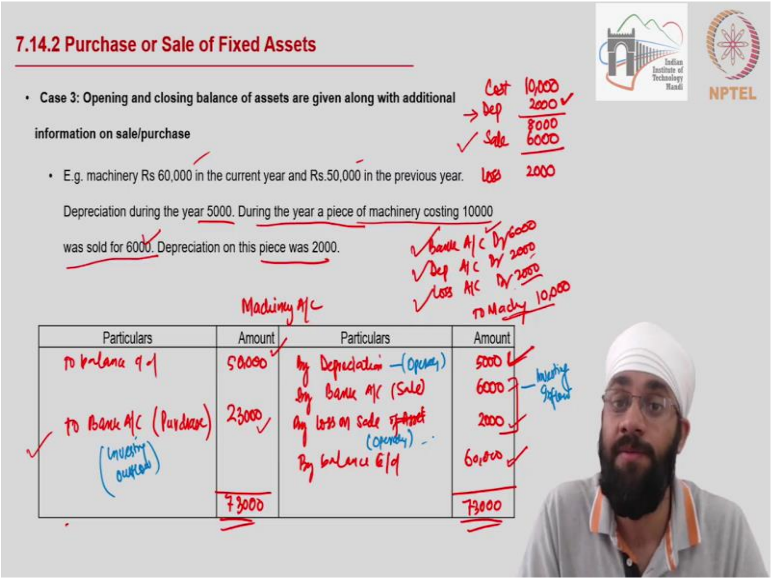


Let us look at the third case, where you have been given information about sale or purchase of the fixed asset. So, we are going to prepare the fixed asset account again. So, you have an opening balance which is 50,000 and closing balance is carried down 60,000; depreciation is 5000. So, we are going to write depreciation as we did earlier, 5000.

The new information is that during the year a piece of machinery which cost 10,000 was sold for 6,000. So, the selling price was 6,000. The depreciation on this specific piece was 2,000 which means this is depreciation, which means the book value of this asset was 8,000 and you sold this for 6,000. So, there is a loss.

There is a loss on sale of 2,000. So, this is new hidden information that we did not have earlier. If you sold the asset for 6,000, the journal entry is going to be By bank account and this is the sale of the asset. 6,000 comes in, but there is also a loss; loss on sale of the asset. Now, we do not have to write assets, just loss on sale and this is 2,000.

Now, this information has to be posted here and then, you do the balances. So, the balance will come out to be 60,000 and then, you have this 11, 12 and 13. So, 73,000 is the total on the credit side and suddenly, we see that the total is not coming out of the equal. There is a balancing figure of 23000 on the debit side. What is this? This is To bank account. What does it mean? This means that there has been a purchase of the fixed asset during the year. There was no information given about this, but when you are preparing the cash flow statement from the two balances; balances of 2 years for fixed assets. And we have a amount of depreciation given in some information, you should prepare this account to figure out if there is a hidden piece of information.

To summarize what happened here was you had 50,000 rupees worth of machinery in the beginning which was increasing by 10,000. So, you would have said that 10,000 is the purchase of the asset. But no, there was depreciation due to which the value of the machinery went down during the year and also, an asset was sold during the year.

So, again value went down. So, effectively 23,000 is the value of the new machinery that you have purchased during the year. Notice that the depreciation on the piece of machinery which is being sold is 2000 rupees, this is included in the 5000. That is why we are not writing it again.

You could write down the journal entry for this if you want to be clearer which would be Bank account debit, Depreciation account debit, and Loss on sale account debit, To machinery. This would be the journal entry. Machinery's value was 10,000, depreciation on this was 2,000, loss was 2,000 and the sale was for 6,000; that is all.

So, in the machinery account we have written By bank 6,000 here, By depreciation 2,000 is included in this 5000, that is why we are not repeating it and By loss 2000, done. Now, you can take these details to their respective places in the cash flow statement. This goes to investing cash flow and this is an outflow. This amount here is an investing inflow because you are selling the asset and money is coming in, the depreciation is added back in the operating section; it goes to the first section.

Loss on sale is also non-operating expense or non-operating loss, this has reduced the profit, this also goes to the operating activity section, the first section. And this is added back to profit to reach the cash operating profit. This is a non-operating item.

So, this is what I wanted to discuss about the purchase or sale of fixed assets and the hidden information that you may need to dig out in order to prepare the cash flow statement with some adjustments.